SUPREME COURT, U. S.
Nos. 380, 381, and 512

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In the Supreme Court of the United States

OCTOBER TERM, 1958

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

JOHN R. HANSEN AND SHIRLEY G. HANSEN

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

BURL P. GLOVER

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT

CLIFTON E. BAIRD AND VIOLET L. BAIRD, PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

BRIEF FOR THE COMMISSIONER

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OPINIONS BELOW

The findings of fact and memorandum opinion of the Tax Court in the *Hansen* case (H.R. 60–68),[1] are not officially reported; the opinion of the Court of Appeals for the Ninth Circuit (H.R. 86–94) is reported at 258 F. 2d 585. The findings of fact and memorandum opinion of the Tax Court in the *Glover* case (G.R. 26–32) are not officially reported; the opinion of the Court of Appeals for the Eighth Circuit (G.R. 36–40) is reported at 253 F. 2d 735. The findings of fact and memorandum opinion of the Tax Court in the *Baird* case (B.R. 43–54) are not officially reported; the opinion of the Court of Appeals for the Seventh Circuit (B.R. 74–86) is reported at 256 F. 2d 918.

JURISDICTION

The judgment of the Court of Appeals in the *Hansen* case was entered on August 4, 1958. (H.R. 95.) The judgment of the Court of Appeals in the *Glover* case was entered on April 23, 1958. (G.R. 41.) The judgment of the Court of Appeals in the *Baird* case was entered on June 20, 1958. (B.R. 87.) The time for filing the petition for a writ of certiorari in the *Glover* case was extended to and including September 20, 1958. (G.R. 42.) The time for filing the petition for a writ of certiorari in the *Baird* case was

[1] The designation "H.R." refers to the printed record in No. 380, *Commissioner of Internal Revenue* v. *John R. Hansen and Shirley G. Hansen;* the designation "G.R.", to the printed record in No. 381, *Commissioner of Internal Revenue* v. *Burl P. Glover;* and the designation "B.R.", to the printed record in No. 512, *Clifton E. Baird and Violet L. Baird* v. *Commissioner of Internal Revenue.*

extended to and including November 17, 1958. (B.R. 88.) The petitions for writs of certiorari in the *Hansen* and *Glover* cases, filed on September 18, 1958, were granted on November 10, 1958. (H.R. 96; G.R. 43.) The petition for a writ of certiorari in the *Baird* case, filed on November 12, 1958, was granted on December 15, 1958. (B.R. 88–89.) The jurisdiction of this Court is invoked under 28 U.S.C., Section 1254.

QUESTION PRESENTED

Whether accrual basis taxpayers who sell property on credit and discount their customers' obligations with finance companies, realizing part of their gain in cash and part in the form of amounts credited to them—the latter portion to be ultimately satisfied either by payment in cash or by offset against the taxpayers' obligations—are required to report the amount of gain so credited (as well as the gain in cash) as income for the year in which the sales and credits are made.

STATUTE AND OTHER AUTHORITIES INVOLVED

Printed in the Appendix, *infra*, pp. 60–70, are Sections 22(a), 41 and 42(a) of the Internal Revenue Code of 1939; Rev. Rul. 57–2, 1957–1 Cum. Bull. 17; Treasury Regulations 111, Sections 29.41–1 and 29.41–2; and G.C.M. 9571.

STATEMENT

The single question in these cases is when accrual basis taxpayers shall treat as income amounts credited to reserve accounts held in their names by finance

companies with which they did business. The taxpayers sold property (principally automobiles and trailers) to customers on credit, and discounted their customers' obligations with the finance companies. The finance companies paid the taxpayers a certain amount in cash and credited them with certain additional amounts. The amounts credited were subsequently to be paid to the taxpayers in cash or used to discharge taxpayers' indebtedness to the finance companies. The Commissioner contends that the amounts credited to the taxpayers should be included in their income for the year in which the sales and credits were made. The taxpayers contend that, even though they were concededly on the accrual basis of accounting, the amounts credited to them should not be included in income until actually received by them.

Hansen, No. 380

In this case, taxpayer (and his wife, with whom he filed joint income tax returns) filed a petition in the Tax Court requesting, among other things, a redetermination of deficiencies in income tax for 1951, 1952 and 1953, in the total amount of $6,903.30. (H.R. 41.) The facts found by the Tax Court (H.R. 61–65), some of which were stipulated (H.R. 5–6), may be summarized as follows:

Taxpayer was engaged in the business of selling automobiles at retail under conditional sales contracts providing for payment of the purchase price in installments. The form of contract used, which was provided by the General Motors Acceptance Corporation (GMAC), called for a "Total Time Price" for

the automobile sold. This was computed by subtracting the down payment (including the trade-in, if any) from the "Cash Sale Delivered Price", and adding to the difference the cost of insurance and finance charges. The amount thus arrived at was called the "Time (Deferred) Balance". The down payment was added back to the "Time (Deferred) Balance" to fix the "Total Time Price". (H.R. 61.)

Taxpayer financed all of the conditional sales through GMAC. Pursuant to the terms of the endorsement contained on each contract,[2] taxpayer

[2] The form contract included the following endorsement (Stip. Ex. 5–E, H.R. 6, 39–40, 62–63):

"For value received, undersigned does hereby sell, assign and transfer to the General Motors Acceptance Corporation his, its or their right, title and interest in and to the within contract, herewith submitted for purchase by it, and the property covered thereby and authorizes said General Motors Acceptance Corporation to do every act and thing necessary to collect and discharge the same.

"The undersigned certifies that said contract arose from the sale of the within described property, warranting that title to said property was at time of sale and is now vested in the undersigned free of all liens and encumbrances; that said property is as represented to the purchaser of said property by the undersigned and that statements made by the purchaser of said property on the statement form attached hereto are true to the best of the knowledge and belief of the undersigned.

"In consideration of your purchase of the within contract, undersigned guarantees payment of the full amount remaining unpaid hereon, and covenants if default be made in payment of any installment herein to pay the full amount then unpaid to General Motors Acceptance Corporation upon demand, except as otherwise provided by the terms of the present General Motors Acceptance Corporation Retail Plan. Liability of the undersigned shall not be affected by any indulgence, compromise, settlement, extensions or variation of terms of the with-

assigned the contract to GMAC in exchange for the amount stated therein, reduced by an amount withheld and placed by GMAC in a reserve account. That account contained at least 5% of the outstanding balances on the contracts assigned to GMAC. Taxpayer was not required to assign any of the contracts to GMAC or to any other finance company, and could have held such contracts himself without assignment. (H.R. 63.)

The reserve was maintained in order to protect GMAC against any loss arising from the repossession of automobiles in the event of default in payment. Also, in the event of purchasers' prepayments, the proportionate reduction in finance charges was charged to the reserve. (H.R 63–64.)

Taxpayer's books of account were maintained, and his returns were filed, on the accrual method. Taxpayer had accounts receivable, and charged off bad debts specifically as they became worthless. The amounts GMAC placed in the dealer's reserve were debited by taxpayer to an account entitled "Due Finance Company", and credited to an account entitled "Reserve for Repossession". Taxpayer did not report any of the amounts credited to him in the reserve account in 1951 and 1953 as income for those years.[3] He did, however, report amounts retained in

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in contract effected with, or by the discharge or release of the obligation of the purchaser or any other person interested, by operation of law or otherwise. Undersigned waives notice of acceptance of this guaranty and notices of non-payment and non-performance."

[3] Taxpayer's 1952 return reported as income the amount of $4,462.27, which GMAC had credited to him in that year in

the reserve account as income in the years when such amounts were paid to him by GMAC. (H.R. 64.)

The Tax Court, sustaining the Commissioner's deficiency determination, held that the amounts credited to taxpayer by GMAC were a part of his gross income in the years in which the credits were made. (H.R. 64–65.) The Court of Appeals reversed the Tax Court's decision on that phase of the case.[4] (H.R. 95.)

Glover, No. 381

In this case, taxpayer filed a petition in the Tax Court requesting, among other things, a redetermination of deficiencies for 1949, 1950 and 1951, in the total amount of $9,002.31. (G.R. 2.) The facts, as stipulated (G.R. 20–25), and as found by the Tax Court (G.R. 26–32), may be summarized as follows:

Taxpayer, operating under the trade name of Glover Motors, was engaged in the business of selling motor vehicles. He kept his books, and (with his wife) filed joint income tax returns for the relevant years, on the accrual basis. (G.R. 27, 38.)

Taxpayer sold cars on credit, receiving notes for the balances due on the purchase price. Pursuant to a written contract prepared by the Universal C.I.T. Credit Corporation (C.I.T.), taxpayer sold and transferred the notes to that company. Certain classes of the notes were transferred without recourse; others

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the reserve account. Taxpayer included the same amount in 1953 income, thus necessitating an adjustment of income for that year. (H.R. 72.)

[4] A penalty issue determined below (H.R. 65–67) is not before this Court.

were transferred with full recourse. (G.R. 27, 37.)

On transfer and delivery of the notes, C.I.T. paid the taxpayer a certain percentage of their face value. A smaller percentage withheld was evidenced on C.I.T.'s books by entry in a so-called dealer's reserve account. Corresponding entries were made on taxpayer's books. (G.R. 20, 37.)

Under its agreement with C.I.T.,[5] taxpayer was obligated, among other things, to repurchase repossessed cars for the unpaid balance due on the notes;

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[5] The agreement, in full, provided as follows (G.R. 27–29):

"*To Universal C.I.T. Credit Corporation:*

"1. You propose to buy from us, on the basis stated in this agreement, paper acceptable to you covering new and used cars; except as provided in this agreement said paper will be assigned to you without recourse as to the customer's obligation of payment, except that paper covering commercial cars used for long distance hauling, commercial cars of more than two tons capacity, busses, cars used for taxi, jitney, "drive yourself" service, or cars sold to relatives or employees will bear our full recourse endorsement; in such cases you may make any necessary correction in our endorsement and paragraphs 2 and 3 shall not apply.

"2. We will purchase from you each repossessed or recovered car tendered at our place of business within 90 days after maturity of the earliest installment still unpaid. The purchase price payable on demand shall be the unpaid balance due on the car, limited as stated in paragraph 3. Until paying you we will store the car at our risk and expense and as your property and will deliver it to you on demand.

"3. We shall have no responsibility as to converted or confiscated cars until they are repossessed or recovered and tendered as above. You will allow us the cost of repairing actual direct collision damage necessitating repossession; the allowance is not to exceed the unpaid balance on the car after deducting both the "as is" value and the amount of any deferred certificate or other special holdback relating to the car. Where the resale value of the repaired car (excluding overhead and

he was also responsible for any deficiency incurred by the finance company in the resale of repossessed cars. C.I.T. was obligated to pay to taxpayer—three times in each twelve months period if taxpayer was not then indebted to it—the accumulated reserves in excess of three percent of the total unpaid balance on

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salesman's commissions) exceeds the unpaid balance, the excess will be deducted from the collision allowance.

"4. Your rate charts will include, for our protection, reserves as outlined in your reserve arrangement effective at the time paper is purchased by you. No reserves are to be set up in respect of short term note, demonstrator or other special plans announced by you from time to time, except as may be agreed upon hereafter in writing. Three times in each twelve-month period, if we are not then indebted to you, you will pay us our accumulated reserves in excess of 3% of the then aggregate unpaid balances on paper purchased from us. If you stop buying our paper, you may hold and apply all reserves until liquidation of all paper purchased from us is completed.

"5. If you refund any part of the service charge because an account is prepaid, we agree to pay you the same percentage of all reserves credited to or paid us on the account as the amount of service refund bears to the amount of the original charge exclusive of insurance premium.

"6. If, in reselling repossessed passenger cars which we purchase from you, covered by paper sold to you in any twelve-successive-month period, we incur a loss (excluding overhead and salesman's commissions) in excess of 3% of the volume of our paper sold you during said period, plus the amount of our reserves for said period, you shall reimburse us for such excess, provided we have resold the cars for their reasonable value within 90 days after delivery to us. We shall credit total profits on resales against total net losses. This paragraph applies only (a) if we have sold you paper covering at least 100 cars during such period, (b) if we perform all of our obligations to you, and (c) if, before incurring such excess losses, we give you written notice of the offered price of each car and the opportunity to resell it.

"7. We will be under full recourse liability to you on the assignment of paper covering equipment other than described

the notes. If C.I.T. stopped purchasing notes from taxpayer, it (C.I.T.) was entitled, under the contract, to hold and apply all reserves against taxpayer's indebtedness to it, until liquidation of all the paper was completed. If C.I.T. became obligated to refund any part of the service charge to a purchaser, the contract provided that taxpayer would pay to C.I.T. the same percentage of all reserves credited or paid

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in paragraph 1 above notwithstanding the language of such assignment, or if in connection with any transaction covering equipment described in paragraph 1 we make any settlement with a customer without your written consent, if we disclose any part of this agreement to the customer, if we breach any provision of the assignment to you, and on paper which bears or in connection with which you receive our guaranty. In any such cases you may make any necessary changes in our endorsements or assignments to express such liability. If we are in default to you under this or any other agreement or obligation at the time of any repossession, cars may be tendered by registered mail notice sent to the last address known by your records, instead of as provided in paragraphs 2 and 3 above; if we are not then doing business as a going concern, tender of repossessed cars is waived. In case we fail to purchase repossessed cars we will be responsible for any deficiency incurred by you in the resale of such repossessed cars at public or private sale held with or without notice, at which you may purchase.

"8. This agreement shall apply to all paper hereafter sold to you as above stated, irrespective of transfers between or extensions of time to customers and until the paper is liquidated, unless otherwise specifically agreed in writing with respect to the particular paper. No waiver or change of any part of this agreement shall be binding on you unless evidenced by writing signed by one of your officers.

"9. The purchase of paper by you from us shall constitute acceptance by you of this agreement, which shall cover all such purchases. This agreement shall inure to and bind our respective successors and assigns and any present and future company affiliated with you which may transact business hereunder."

to it on the account as the amount of the refund bore to the original charge, exclusive of insurance premium. (G.R. 28–29, 37.)

The following amounts, representing three percent of customers' notes outstanding, were reflected in the dealer's reserve account at the end of the indicated years, but were not reported as income by taxpayer: 1949—$3,885.71; 1950—$7,601.07; 1951—$7,952.41. (G.R. 30–31, 37.) The Commissioner determined deficiencies by including the amounts in income in the respective years in which they were credited to the reserve account. (G.R. 31, 37.) The Tax Court sustained the deficiencies. (G.R. 32–33.) On appeal, the Court of Appeals reversed. (G.R. 41.)

Baird, No. 512

In this case, taxpayers, husband and wife, doing business as equal partners under the name of Baird Trailer Sales, filed petitions in the Tax Court requesting redetermination of income tax deficiencies for the calendar years 1952, 1953, and 1954, aggregating $47,020.60. (B.R. 57.) The deficiencies resulted from the Commissioner's action in treating as partnership income for the fiscal years ended February 28, 1952, 1953, and 1954 amounts credited in those years (in the name of the partnership) to so-called dealers' reserve accounts maintained by finance companies to which the partnership had sold the notes, chattel mortgages and unconditional sales contracts of its vendees. (B.R. 24–25.) The facts, as stipulated (B.R. 13–22) and as found below (B.R. 44–54; 75–79), may be summarized as follows:

Taxpayers filed joint returns on a cash basis for the calendar years involved. The partnership, which since its organization in January 1947 had been engaged in the sale of new and used mobile homes, or house trailers, and to a lesser extent in new and used cars, parts and accessories, furniture, and real estate, kept its books and filed its income tax returns on the accrual basis. Partnership returns were filed for the fiscal years ended February 28, 1952, 1953, and 1954, and an amended return was filed for the fiscal year ended February 28, 1952. (B.R. 44.)

During the taxable years, the partnership sold, to either of two finance companies [6] or a bank [7] (collectively referred to as finance companies), unpaid notes, chattel mortgages and conditional sales contracts (collectively referred to as retail paper). The proceeds of such sales were paid by the finance companies to the partnership, with this exception: a part was withheld by each finance company and credited to the dealer's reserve account of the partnership on the finance company's books.[8] The partnership either endorsed with recourse the retail paper sold to the finance companies, or guaranteed its payment. (B.R. 75–76.) It was agreed between the partnership and

[6] Minnehoma Financial Company of Tulsa, Oklahoma (referred to as Minnehoma); Midland Trailer Finance Corporation (referred to as Midland). (B.R. 44.)

[7] Michigan National Bank of Grand Rapids, Michigan (referred to as Michigan). (B.R. 44.)

[8] The part withheld by Michigan was deposited in an account designated "dealer escrow account" in the name of the partnership. (B.R. 50.)

the finance companies, either orally or in writing, that (B.R. 76):

> (a) In the event the retail paper became due and unpaid, the finance company could charge the dealer's reserve with the unpaid balance;
>
> (b) In the event the partnership had a matured financial obligation of any nature to the finance companies, the amount of such obligation could be charged to the dealer's reserve account;
>
> (c) Repossession losses of the finance companies could be charged to the dealer's reserve account;
>
> (d) The ultimate balance in the dealer's reserve account after payment of all notes by the partnership to the finance companies was to be paid to the partnership; and
>
> (e) Each finance company could look to the balance in the dealer's reserve account to satisfy any default by the partnership on its guaranties and obligations to the finance company, as well as any default by the makers of the notes.

Under the terms of the separate agreements with Minnehoma, Michigan, and Midland,[9] the partnership

[9] The record shows the following written agreements entered into between taxpayers and the finance companies:

The agreement with Minnehoma. The partnership and Minnehoma signed a document, dated December 30, 1949, relating only to new trailer coaches manufactured by the Spartan Aircraft Company, entitled "Agreement Covering Purchase of Conditional Sales Contract". Among other things, it provided, as follows (B.R. 45–46):

"1. The Dealer shall not be obligated to sell any conditional sales contracts to Minnehoma, but may offer Minnehoma such contracts as the Dealer may from time to time choose, and

sold most of its trailer notes for the deferred purchase price of the trailers, plus, in certain cases, a percentage of the interest or finance charges. As each note was transferred to it with recourse, the finance company remitted to the partnership the amount due it on the selling price of the trailer as above described, less an amount which was credited on

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Minnehoma shall not be obligated to purchase or acquire any contracts offered for sale and assignment by the Dealer, but shall purchase only such contracts as it is willing to do. This agreement shall govern only the sale and assignment of such conditional sales contracts as the Dealer shall elect to sell and Minnehoma shall indicate its willingness to purchase and acquire.

* * * * * *

"6. The purchase price of each conditional sale contract purchased by and assigned to Minnehoma hereunder shall be equal to the retail cash sales price of the trailer coach and all extra equipment plus all sums paid by the Dealer as required hereunder for sales and other taxes, extras and filing and recording fees less the amount of the down payment made by the purchaser in cash and/or by trade-in allowance.

"7. The Dealer unconditionally guarantees the payment of all sums required to be paid under each conditional sale contract purchased by and assigned to Minnehoma hereunder when such payment shall become due. In the event that the purchaser defaults or fails to pay any installment due under any conditional sale contract purchased by and assigned to Minnehoma hereunder, the Dealer agrees to demand of Minnehoma to pay such sum then due or, upon request of Minnehoma, to re-purchase from Minnehoma for the entire balance remaining unpaid under said conditional sale contract. * * *"

There was no provision in the 1949 agreement for the withholding of any dealer reserve by Minnehoma. (B.R. 46.)

On November 8, 1950, the aforementioned December 30, 1949, agreement with Minnehoma was superseded by an "Agreement Covering Purchase of Conditional Sales and Other Time Sales Contracts", paragraphs 6 and 7 of which provided as follows (B.R. 46-47):

its books to an account in the name of the partnership (designated "Dealer Reserve Account" by Minnehoma and Midland, and "Dealer Escrow Account" by Michigan). The amount withheld and credited to such account was usually 5 percent of the unpaid balance on each note, though in some cases the figure was 3 percent. In certain instances, Minnehoma and Mid-

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"6. The purchase price of each contract purchased by and assigned to Minnehoma hereunder shall be equal to 95% of the aggregate of the retail cash sales price of the trailercoach and all extra equipment and all sums paid by the Dealer as required hereunder for sales and other taxes, extras and filing and recording fees less the amount of the down payment made by the purchaser in cash and/or by trade-in allowance.

"7. An amount to be determined by Minnehoma from time to time in its absolute discretion equal to not more than 5% of the aggregate of the retail cash sales price of the trailercoach and all extra equipment and all sums paid by the Dealer as required hereunder for sales and other taxes, extras and filing and recording fees less the amount of the down payment made by the purchaser in cash and/or by trade-in allowance will be credited by Minnehoma to a special reserve account in the name of the Dealer hereunder as to each contract purchased by and assigned to Minnehoma hereunder, which account will be referred to as the "Dealer Reserve Account". In addition, Minnehoma may credit to such Dealer Reserve Account hereunder, but shall not be obligated so to do, one-fifth (1/5) on new trailers and one-sixth (1/6) on used trailers, or such other portions as Minnehoma may determine from time to time, of the finance charge paid or agreed to be paid by the purchaser in each contract. In addition to and without affecting any or all of its rights hereunder, Minnehoma may, at its option, charge against the Dealer Reserve Account any sums that the Dealer may at any time owe to Minnehoma in any connection whatsoever. In the event and at such time or times as the Dealer Reserve Account shall exceed 15% of the aggregate unpaid balances of all contracts purchased by and assigned to Minnehoma hereunder by the Dealer plus all contingent liabilities which, on the sole determination of Minne-

land also credited to the partnership's account a portion of the finance charge. At the time of sale, the finance companies sent the partnership a memorandum of the amount thus withheld and credited. The partnership also received periodic statements of the balances in the accounts. (B.R. 49–50.)

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homa, it may have with respect to such contracts, Minnehoma will pay such excess to the Dealers from time to time as determined by Minnehoma but not more frequently than once each month. In the event that and at such time as all contracts as shall have been purchased and assigned to Minnehoma by the Dealer shall have been paid in full and no sums shall remain unpaid thereunder and in the opinion of Minnehoma there shall be no contingent liability on the part of Minnehoma with relation thereto, Minnehoma shall pay to the Dealer the balance of the credit in such Dealer Reserve Account. Minnehoma's determination as to the possibility of contingent liability shall be final and not subject to question by the Dealer."

Credits to the dealer reserve account, in amounts usually five percent of the aggregate retail cash sales price of the trailer, were entered on the books of Minnehoma. The 1950 agreement, as did the December 30, 1949 agreement, provided that the dealer-partnership "unconditionally guarantees the payment of all sums required to be paid under each contract purchased by and assigned to Minnehoma hereunder when such payment shall become due". (B.R. 47.)

On December 21, 1950, the amount of finance charge that Minnehoma had been crediting to the partnership's reserve account was changed from one-fifth to one-tenth on new trailers, and from one-sixth to one-twelfth on used trailers, effective January 1, 1951. (B.R. 47.)

The agreement with Michigan. The written portion of the agreement between the partnership and Michigan is contained in a "Collateral Assignment", providing, in part, as follows (B.R. 47–48):

"For Valuable Consideration, the receipt of which is hereby acknowledged, the undersigned hereby sells, assigns, transfers, and conveys unto Michigan National Bank, of Grand Rapids, Michigan, its successors, and assigns forever irrevocably, all of

The partnership was not required by any finance company to do business with it to the exclusion of any other company. The partnership was not financially

his, its, or their right, title and interest in certain sums of money now on deposit or that may hereafter be deposited in the Michigan National Bank, of Grand Rapids, Michigan, and identified and represented by Reserve account in the name of the undersigned in the Michigan National Bank.

"This Assignment and Transfer is made as collateral security for the payment of the direct and indirect liability of the undersigned to the said Michigan National Bank of Grand Rapids, Michigan, and to secure the payment of the several notes representing said direct and indirect liability and any renewal or renewals thereof, or any installment payment or payments and to secure any obligation which may arise which the undersigned may owe to said Michigan National Bank of Grand Rapids, Michigan.

"In the event of default in the payment of said liability or any installment thereof, or any of the several notes at the time when same shall fall due or in the payment of the interest thereon or any part of the principal of said liability then the Michigan National Bank, of Grand Rapids, Michigan, at their election, notice of said election being hereby expressly waived, may apply the total of said sums of money represented by said Reserve account at the date of election or any part thereof to meet the default in the liability.

"Whenever the indebtedness secured hereby is paid in full the Michigan National Bank, of Grand Rapids, Michigan, shall reassign said sums of money represented by said Reserve account along with all right, title and interest back to the undersigned.

"If in the opinion of the bank the undersigned dealer's account is in good standing, all sums in this reserve account in excess of ten per cent (10%) of the gross unpaid balance of all contracts outstanding on February 28 of each year will promptly be returned to the undersigned dealer."

The above agreement did not contain the provisions by which amounts representing a percentage of the aggregate sales price of the trailers, or amounts representing a percentage of the

able to carry the contracts of sale or the floor plan [10] and, at the same time, to carry the inventory of trailers held for sale. It accordingly relied upon the finance companies. For its own convenience, it procured and used in its sales legal forms furnished by the finance companies. (B.R. 76.)

The dealer's reserve account on each finance company's books was reflected as a liability of the finance

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finance charge, were credited to the partnership's account on the finance company's books. (B.R. 49.)

The agreement with Midland. The written portion of the original agreement between the partnership and Midland is embodied in two letters, written by Midland, dated December 3 and 18, 1951, containing, in part, the following (B.R. 49):

"* * * The retail paper is to be endorsed by you with recourse.

"Our advance on new trailer paper will be 97% on the unpaid cash balance and on used trailer paper, for 95% on the unpaid cash balance. The differentials of 3% and 5% will accumulate to provide you with a loss reserve. When this reserve fund exceeds 10% of your outstandings, the excess will be paid to you automatically."

On and after June 10, 1952, the partnership notes were sold to Midland under the terms of a letter from Midland dated June 4, 1952, providing, in part, as follows (B.R. 49):

"Beginning on June 10, we will set up a dealer profit reserve equal to 1% of the unpaid cash balance of each retail contract. This profit reserve will be derived from the service charge and it will be paid to the dealer when the retail contract is paid out.

"Effective also on June 10, the dealer reserves of 3% on new transactions and 5% on used transactions, will be paid to the dealer when the contract is paid out. This procedure will be followed on all types of payoffs, including payment by the purchaser at maturity, anticipation by the purchaser or payment by the dealer in the cases of trade-ins or repossessions."

[10] This is the term used to describe loans made by a finance company to a dealer in order to finance the dealer's purchase of stock-in-trade. See *Shoemaker-Nash, Inc.* v. *Commissioner*, 41 B.T.A. 417, 420.

company, and the annual balances in such account were not reflected in its income. (B.R. 51.)

The following illustrates a typical trailer sales transaction (B.R. 18):

Sales Price of Trailer	$5,545.00
Cash Down Payment (and/or Trade-in Allowance)	1,745.00
Balance Due Baird Trailer Sales	3,800.00
VSI (Skip Insurance), Credit Check, Insurance	420.00
Principal (Amount of Note)	4,220.00
Financing Charges Paid to Finance Company	1,265.80
Balance Due Baird Trailer Sales	3,800.00
Credited to Reserve of Baird Trailer Sales	190.00
Cash Paid Baird Trailer Sales by Finance Co.	$3,610.00

Prior to receipt of the remittance from the finance company, such a transaction was recorded on the books and records of the partnership as follows (B.R. 18, 51):

Sales Receipt Journal Entry

Cash and/or Trade-in Allowance	$1,745.00	
Contracts Receivable—Finance Company	3,800.00	
Trailer Sales		$5,545.00

When the finance company remitted to the partnership, the following entries were made (B.R. 18, 51–52):

Reserve—Finance Company	$190.00	
Cash	*3,632.67	
Expense for Intangible Stamps	1.38	
Contracts Receivable		$3,800.00
Expenses (Credit Check)		24.05
		3,824.05
Cost of Sales	3,824.05	
Credit Inventory		3,824.05

*It may be noted that the amount in excess of $3,610 debited to cash ($22.67), when added to the amount debited to expense ($1.38), equals the total amount credited to expense ($24.05).

When a purchaser defaulted on his contract and note, the trailer was repossessed upon receipt of notice of default. The partnership always paid the finance company the unpaid balance due on such note, and recorded such payment on its books and tax returns as a purchase. Where defaults occurred on the notes payable to the partnership, the payments made to the finance companies as a result of the defaults were included in the partnership's returns for the taxable years as a part of cost of goods sold. On resale of the repossessed trailer, the receipts therefrom were reported as gross receipts.[11] (R. 52.)

[11] For example, if a trailer costing $5,545, with notes payable outstanding of $3,500, was repossessed, and the trailer's fair market value was only $3,000, the loss, if any, was reflected on the partnership's books and records as part of cost of goods as follows: The bookkeeper of the partnership, either on the date of repossession or at the close of the fiscal year, charged $500 to overallowance on trailers, and recorded the purchase price of the trailer in cost of used trailers at $3,000 (its fair market value). However, if the trailer was sold during the fiscal year in which it was repossessed, and the bookkeeper had not charged $500 to overallowance on trailers, the purchase price of the trailer was reflected in cost of used trailers at $3,500, and the sales price of $3,000 was reported in gross receipts. In the event the notes payable outstanding were $3,000 or less in the above example, the purchase price of the trailer was reflected in cost of used trailers at the amount paid by the partnership on the unpaid balance of the note payable. The finance company remitted to the partnership the amount which had been credited to the account designated "Dealer's Reserve" with respect to such defaulted contract and note, and the partnership reported such amount in taxable income for the year of receipt, except that for the years 1947 and 1948, the credits to the "Dealer's Reserve" were included in taxable income. (B.R. 52–53.)

The following table shows the amounts credited on the books of Minnehoma, Michigan, and Midland to the dealer reserve accounts of the partnership, and the amounts which the partnership received out of such accounts from those companies and from other finance companies in the years indicated (B.R. 53):

Fiscal year ended February 28	Credited by Minnehoma, Michigan, and Midland in dealer reserve accounts of partnership	Received by partnership from all finance companies
1952	$25,816.58	$1,217.94
1953	29,560.54	1,778.94
1954	29,660.49	9,141.39

On its returns for the taxable years, the partnership deducted specific bad debts in the respective amounts of $1,203.75, $2,239.12, and $1,203.69. The deductions, in part, reflected unpaid amounts due the partnership for accessories, supplies and repairs. They also reflected purchasers' defaults with respect to advances made by the partnership to enable the purchasers to meet trailer payments. (B.R. 53.)

No delinquent notes were charged to the dealers' reserve accounts. During the taxable years the finance companies were in such good financial condition that they were able to pay any accounts which might have been due and payable to the partnership out of the reserve accounts. (B.R. 79.)

In computing the gross receipts reported in its returns for the taxable years, the partnership deducted from gross sales the total amount credited by the finance companies in each year to the dealers' reserve accounts. The Commissioner included such

amounts in the partnership's income. In determining the contested deficiencies, the Commissioner reduced the total amounts credited by the finance companies to the dealers' reserve accounts by the amounts which the partnership received from the finance companies in the taxable years, and added the net amounts to the partnership's income. (B.R. 53–54.)

The Tax Court held that the amounts credited to the partnership in the dealers' reserve accounts were includible in taxpayer's income in the years in which the credits were made. The Court of Appeals affirmed the decisions of the Tax Court. (B.R. 54, 87.)

SUMMARY OF ARGUMENT

Taxpayers in all three cases before the Court are on the accrual basis. All are dealers who sold automobiles and trailers to customers on credit for what is generally designated as a time purchase price (representing the difference between the total purchase price, including finance and other charges, and the amount paid by the customer in cash, plus the trade-in allowance, if any). Taxpayers did not retain their vendees' notes (or other commercial paper). Instead, they discounted their customers' obligations with finance companies. The dealers thereupon received the major part of the consideration paid by the finance companies in cash. The balance of the consideration was credited to them in so-called dealers' reserve accounts. It is the taxability of the amounts so credited which is here in issue.

There can be no doubt that taxpayers on the accrual basis must report in a given year (the annual

accounting period) all income which they have acquired a fixed right to receive in that year, even though actual receipt may be deferred. It is equally settled that the right to receive income is deemed fixed even though there is a possibility—a normal business risk—that the income (or a portion of it) may prove uncollectible. In the absence of abnormal contingencies which make the possibility of payment remote, the creditor must, as of course, accrue the debtor's obligation—a procedure which is the very essence of accrual accounting.[12] The ordinary rules govern the instant cases.

The very types of credit here involved—credits held by automobile finance companies for automobile dealers in so-called dealers' reserve accounts—have been the subject of administrative pronouncement and practice since 1931. Consistently, such credits have been treated as income which has accrued to the dealer in whose favor the credit stands. Regularly, since 1940, when it first dealt with the issue, the Tax Court has taken the same view. During the 27-year period in which the administrative practice has been regularly maintained, Congress has made

[12] A taxpayer on the accrual basis is, of course, entitled to appropriate deductions for bad debts. He must either claim such deductions specifically, or, in appropriate circumstances, elect to employ reserves for bad debts. There is no issue as to deductions before the Court. Indeed, the records in these cases show that taxpayers specifically charged off bad debts; they did not elect to set up reserves for bad debts. If bad debt reserves were to be established in the future, they would have to be justified by demonstrated past experience as to the rate and magnitude of debtors' delinquencies.

two complete revisions of the Internal Revenue Code. It has not seen fit to make any change in the law.

Analytically, two typical transactions are involved. The first is the sale of an automobile by the dealer to the purchaser, accompanied by the execution of a promissory note by the purchaser, payable to the dealer. If matters stopped there—if the dealer retained the commercial paper, as in each instance he had every right to do—there could be no question raised as to the accrual of income. The situation would be like that of every commercial seller who offers goods or services on credit and receives a promise of payment, whether express or implied; an obligation then and there accrues.

The second transaction is the assignment of the commercial paper by the automobile dealer to a finance company, ordinarily accompanied by some undertaking on the part of the dealer in the event of delinquency by the automobile purchaser. However, this nowise affects the conclusion that the taxpayer accrued his gain immediately upon the completion of the sale. Certainly, a business man who goes to a bank or lending agency and assigns or pledges accounts receivable in order to obtain working capital does not thereby dissipate the accrued income represented by those accounts receivable.

Those Courts of Appeals which have ruled against the Commissioner's position have proceeded upon the assumption that there are not in truth two transactions, but, rather, a single three-cornered transaction. The suggestion is that the working relationship between the dealers and the finance companies is so

close that, realistically speaking, the dealer sells to the automobile purchaser but receives his payment through the finance company (a suggestion made in the face of the fact that none of the dealers was under any obligation to deal with any of the finance companies involved). These courts then take the view that such amounts as are not immediately paid by the finance company to the dealer in cash, *i.e.*, the amounts credited to him in the dealers' reserve accounts, are contingent liabilities which do not accrue until payment is made.

But even if one would be justified, contrary to our view, in ignoring the two discrete legal transactions involved, there is no sound basis, we submit, for the result reached by the courts which have adopted the "single-transaction" approach. The fact is that the dealer who works with or through a finance company has not thereby added to the risks or contingencies upon which his receiving full payment depends. The risk that he may not ultimately receive all of the monies credited to him in the dealers' reserve account turns on the possibility that automobile purchasers may default and the repossessed value of the cars may prove insufficient to satisfy the balance due from the purchasers. This is precisely the same risk as is taken by every person who sells on credit. Neither sound analysis nor consideration of the practical realities justifies the conclusion that the interposition of the finance company makes a change in the dealer's tax liabilities.[8] With or without a finance company in the picture, we submit that the dealer's gain accrues when the sale is completed, at which time

the obligation of the automobile buyer is fixed and the amount of income derived by the dealer becomes determinate.

ARGUMENT

The amounts credited to taxpayers, like the rest of the gain from sales of their property, were accruable as income for the year in which the sales and credits were made

These three cases involve accrual basis taxpayers (automobile and trailer dealers) who sold property to customers on credit and discounted their customers' credit obligations with finance companies. Since the customers' duty to pay the entire purchase price became fixed upon sale of the property, it is apparently undisputed that the taxpayers would have been required to accrue their entire gain upon consummation of such sales if they had retained their customers' credit obligations. In that circumstance, they could not have delayed accrual of any part of their gain from the sales merely because actual payment of the balance of the purchase price was to be postponed and customers might subsequently default in their payments.

Nor, we submit, are the taxpayers afforded any basis for deferring part of their gain because of the interposition of the finance companies. The finance companies acquired—necessarily from the taxpayers who sold the property—the customers' absolute obligations to pay the balance of the purchase price of such property and the dealers' contingent obligations to make good any losses which the finance companies

might subsequently suffer upon customers' defaults. The reciprocal consideration moving from the finance companies to the taxpayers was twofold—the payment of a certain amount in cash and the credit of a certain additional amount to the dealers' accounts (the so-called "dealers' reserves"). The finance companies treated the amount credited to such reserves as their liability to the dealers. Once any amount was credited to a dealer's reserve, only one of two dispositions could be made of it—(1) it would be subsequently paid to the dealer in cash, or (2) it would subsequently be used to discharge the dealer's indebtedness to the finance company. The latter alternative is no different from the receipt of cash so far as the accrual of income is concerned. Once the right to income becomes fixed, it has accrued, even though actual payment is postponed.

Consistently with this view, the Court of Appeals for the Seventh Circuit, in *Baird* v. *Commissioner* (B.R. 74–86), No. 512, concluded that the dealer's right to receive the amounts credited to its favor in the reserve accounts became fixed, even though actual payment was deferred, when the credits were made; that, in any event, the right to the full time price (which would include the amounts reflected in the dealer's reserves) became fixed when that amount had been agreed upon between the dealer and its vendees, and the retail paper had been executed in favor of the dealer; and that, consequently, there was an accrual

of income in the year when the sales and the credits to the reserve accounts were made.[13]

This view, which follows the consistent administrative practice (Rev. Rul. 57–2, 1957–1, Cum. Bull. 17 (Appendix, *infra*, pp. 61–64); G.C.M. 9571, X–2 Cum. Bull. 153 (1931) (Appendix, *infra*, pp. 65–70)), has been espoused for more than seventeen years by the Tax

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[13] There is no deduction question before this Court. Of course, as the Court of Appeals noted in *Baird* (B.R. 82–83), an accrual basis taxpayer may take appropriate specific deductions, and, indeed, in the *Baird* case "Actually the partnership elected, on its returns for the relevant years to use the bad debt deduction method". So, too, in *Hansen*, "Taxpayer used a specific charge-off account for bad debts arising from the business". (H.R. 87.) And in *Glover* the record shows that the taxpayer deducted bad debt expenses of some $1800 for 1949, $7300 for 1950, and $4100 for 1951. (G.R. 31.) To the extent that their business experience warranted, taxpayers might have elected to set up a reserve for bad debts under Section 23(k)(1) of the Internal Revenue Code of 1939. They did not do so but chose instead to use the specific charge-off method. In any event, they do not claim that the amounts credited to them by the finance companies constituted deductible bad debt reserves. Rather, they are contending that those amounts are not income. Moreover, they have never purported to demonstrate that the amounts credited to them in the dealers' reserve accounts in each of the years involved constituted, in the terms of the statute, "(in the discretion of the Commissioner) a reasonable addition to a reserve for bad debts". Absent a showing of a correspondence between the rate of delinquency on the part of their vendees and the amounts set aside in the dealers' reserve accounts, any claimed deductions for a reasonable addition to a reserve for bad debts based on the credits to the dealers' reserve accounts would have to be denied as artificially grounded. Cf. *Automobile Club* v. *Commissioner*, 353 U.S. 180, 189.

Court [14] and has been adopted by the Sixth Circuit

[14] *Shoemaker-Nash, Inc.* v. *Commissioner*, 41 B.T.A. 417 (1940); *Colorado Motor Car Co.* v. *Commissioner*, decided March 25, 1940 (1940 P-H B.T.A. Memorandum Decisions, par. 40,178); *Royal Motors, Inc.* v. *Commissioner*, decided July 12, 1945 (1945 P-H T.C. Memorandum Decisions, par. 45,255); *Town Motors, Inc.* v. *Commissioner*, decided July 24, 1946 (1946 P-H T.C. Memorandum Decisions, par. 46,173); *Ray Woods Used Cars, Inc.* v. *Commissioner*, decided September 30, 1952 (1952 P-H T.C. Memorandum Decisions, par. 52,290); *Central Motors, Inc.* v. *Commissioner*, decided August 12, 1954 (1954 P-H T.C. Memorandum Decisions, par. 54,228); *Koch Motors* v. *Commissioner*, decided December 30, 1955 (1955 P-H T.C. Memorandum Decisions, par. 55,334); *Johnson* v. *Commissioner*, 25 T.C. 123 (1955), reversed, 233 F. 2d 952 (C.A. 4th); *Brodsky* v. *Commissioner*, 27 T.C. 216 (1956); *Texas Trailercoach, Inc.* v. *Commissioner*, 27 T.C. 575 (1956), reversed, 251 F. 2d 395 (C.A. 5th); *West Pontiac, Inc.* v. *Commissioner*, 27 T.C. 749 (1957), reversed, 257 F. 2d 810 (C.A. 5th); *Morgan* v. *Commissioner*, 29 T.C. 63 (1957), pending on appeal (C.A. 9th); *Kilborn* v. *Commissioner*, 29 T.C. 102 (1957), affirmed (C.A. 5th), September 18, 1958 (2 A.F.T.R. 2d 5812), petition for writ of certiorari pending; *Glover* v. *Commissioner*, decided March 18, 1957 (1957 P-H T.C. Memorandum Decisions, par. 57,045), reversed, 253 F. 2d 735 (C.A. 8th); *Schaeffer* v. *Commissioner*, decided April 30, 1957 (1957 P-H T.C. Memorandum Decisions, par. 57,068), affirmed, 258 F. 2d 861 (C.A. 6th); *Hansen* v. *Commissioner*, decided June 28, 1957 (1957 P-H T.C. Memorandum Decisions, par. 57,113), reversed, 258 F. 2d 585 (C.A. 9th); *Baird* v. *Commissioner*, decided October 9, 1957 (1957 P-H T.C. Memorandum Decisions, par. 57,192), affirmed, 256 F. 2d 918 (C.A. 7th); *Wiley* v. *Commissioner*, decided December 23, 1957 (1958 P-H T.C. Memorandum Decisions, par. 52,236, pending on appeal (C.A. 6th). See also, *Key Homes, Inc.* v. *Commissioner*, 30 T.C. 109 (1958) pending on appeal (C.A. 6th). Cf. *Beaudry* v. *Commissioner*, decided February 14, 1941 (1941 P-H B.T.A. Memorandum Decisions, par. 41,114), where the Board of Tax Appeals apparently concluded that the dealer did not have the right to receive, either periodically *or ultimately*, any portion of the reserve not in excess of a certain percentage of the total notes outstanding.

(*Schaeffer* v. *Commissioner*, 258 F. 2d 861 (C.A. 6th)). Contrary results have been reached, however, in the *Hansen* and *Glover* cases, Nos. 380, 381, decided by the Ninth and Eighth Circuits, respectively, and by two other circuits. See the decisions of the Court of Appeals for the Fourth Circuit in *United States* v. *Colonial Chevrolet Corp.*, affirming, January 5, 1959, the judgment of the District Court for the Eastern District of Virginia, 2 A.F.T.R. 2d 5704, *United States* v. *Marine Chevrolet Co.*, affirming, on December 12, 1958, on stipulation, 161 F. Supp. 62 (E.D.N.C.); *Johnson* v. *Commissioner*, 233 F. 2d 952 (C.A. 4th); and the decisions of the Court of Appeals for the Fifth Circuit in *Texas Trailercoach, Inc.* v. *Commissioner*, 251 F. 2d 395; *West Pontiac, Inc.* v. *Commissioner*, 257 F. 2d 810; *United States* v. *Hines Pontiac*, decided September 6, 1958 (2 A.F.T.R. 5694); *United States* v. *Modern Olds, Inc.*, decided September 15, 1958 (2 A.F.T.R. 2d 5713); and *Kilborn* v. *Commissioner*, decided September 18, 1958 (2 A.F.T.R. 2d 5812).

I. The applicable principles

A. *The fixed right to receive*

Section 41 of the Internal Revenue Code of 1939 (Appendix, *infra*, pp. 60–61), and Sections 29.41–1 and 29.41–2 of Treasury Regulations promulgated thereunder (Appendix, *infra*, pp. 64–65), authorize taxpayers (with exceptions not relevant here) to choose the accounting method by which they are to keep their books and compute their income for tax purposes. The effect on gross income of choosing the accrual method, selected by taxpayers in the cases at bar, was

explained by this Court in *Spring City Co.* v. *Commissioner*, 292 U.S. 182, 184, as follows:

> Keeping accounts and making returns on the accrual basis, as distinguished from the cash basis, import that it is the *right* to receive and not the actual receipt that determines the inclusion of the amount in gross income. When the right to receive an amount becomes fixed, the right accrues.

Under settled principles of tax law, therefore, it is the right to receive and not the actual receipt of an item of income which determines its includibility in gross income under the accrual method of accounting. *Brown* v. *Helvering*, 291 U.S. 193; *Spring City Co.* v. *Commissioner, supra.* As explained more fully below, taxpayers in the instant cases acquired a fixed right to receive the amounts credited to them, as well as the rest of the gain from sales of their property, in the year in which the sales and credits were made. Accordingly, inclusion of those amounts in such year was in accordance with the accrual method of accounting for tax purposes.[15]

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[15] That the accounting practice adopted by taxpayers in the instant cases differed from this view—even if it is assumed, *arguendo*, that the practice was correct from a theoretical or business accounting viewpoint—is, of course, not controlling here. "The income tax laws do not profess to embody perfect economic theory. They ignore some things that either a theorist or a business man would take into account in determining the pecuniary condition of the taxpayer." *Weiss* v. *Wiener*, 279 U.S. 333, 335. See also, *Lucas* v. *American Code Co.*, 280 U.S. 445, 449; *Brown* v. *Helvering*, 291 U.S. 193, 203. "* * * the form of a transaction as reflected by correct corporate accounting opens questions to the proper application of a taxing statute; it does not close them." *Bazley* v. *Commissioner*, 331 U.S. 737, 741.

Taxpayers' right to receive the face amount of the retail paper executed in their favor was not rendered non-accruable merely because the paper might not prove collectible when due. *Spring City Co.* v. *Commissioner, supra; Automobile Ins. Co.* v. *Commissioner,* 72 F. 2d 265 (C.A. 2d); *K. Taylor Distilling Co.* v. *Commissioner,* 42 B.T.A. 7. That possibility constitutes a normal business risk which does not justify postponement of accrual. *Elmer* v. *Commissioner,* 65 F. 2d 568 (C.A. 2d); *Alworth-Washburn Co.* v. *Helvering,* 67 F. 2d 694 (C.A.D.C.).

Nor was the taxpayers' right to receive payment from the amounts credited to the dealers' reserve accounts rendered non-accruable by the provisions of the agreements between them and the respective finance companies. Taxpayers would ultimately receive payment of the credits either in cash or in the offset of their obligations to the finance companies. Accordingly, they realized income when the credits were made. The alleged "contingencies" with respect to the payments from the dealers' reserve accounts were not sufficiently substantial, either from the standpoint of the legal liability of the finance companies to pay over or from the standpoint of collectibility, to prevent accrual of income. The contrary arguments of taxpayers, as expressed below, fail to distinguish between the concepts of payment and vesting. As the Court of Appeals observed in the *Baird* case (B.R. 86):

> Taxpayers confuse the arrangement with respect to *payment* of the sums in the reserve accounts with the vesting * * * in the relevant years of a fixed right to receive in due course

> definite sums which had become accruable * * * at the times of sale * * *. There is no uncertainty with respect to the amounts accrued * * *. These amounts were definitely fixed at the time the funds were placed to * * * [taxpayer's] credit in the * * * reserve accounts. Moreover, there is no showing that the amounts in the reserve accounts would not be collectible at the appropriate time or that collection would be improbable * * *. In the light of the record, it cannot logically be argued that the reserve would never be realized * * *.[16]

B. *The concept of an annual accounting*

Section 41 of the 1939 Code requires that every taxpayer, regardless of his accounting method, compute his income on the basis of an annual accounting period. Since income is by its very nature a flow, rather

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[16] Even if it is assumed, *arguendo*, that in the instant cases the exact amounts in the dealers' reserve accounts which taxpayers had a right to receive was in dispute, and that eventually they might actually receive only part, or even none, of the amounts credited; accruability is not necessarily foreclosed. Under the claim of right doctrine first enunciated by this Court in *North American Oil* v. *Burnet*, 286 U.S. 417, and reaffirmed in *United States* v. *Lewis*, 340 U.S. 590, and *Healy* v. *Commissioner*, 345 U.S. 278, taxpayers still would be obliged to report the amounts in the reserves as income, when the credits were made. The decisions make it clear that the claim of right doctrine applies to accrual, as well as cash basis, taxpayers. See *North American Oil* v. *Burnet*, *supra*, pp. 421–422, 423–424, affirming 50 F. 2d 752, 755–756 (C.A. 9th); *Brown* v. *Helvering*, *supra*, pp. 199–200; *Clay Sewer Pipe Assn.* v. *Commissioner*, 139 F. 2d 130, 132 (C.A. 3); *South Dade Farms* v. *Commissioner*, 138 F. 2d 818 (C.A. 5th). And, on principle, there would seem to be no warrant, in applying the doctrine, for distinguishing between the actual receipt of income and the fixation of the right to receive it.

than a static condition or object, the imposition of a tax upon income requires that points of time be fixed between which income is measured for tax purposes. Computation of income on such an annual basis is, as a general matter, essential both to assure the Government a regular and ascertainable production of revenue and to provide a system susceptible of practical operation. See *Burnet* v. *Sanford & Brooks Co.*, 282 U.S. 359, 365; *Brown* v. *Helvering*, 291 U.S. 193, 199. Since income-producing transactions often extend over a period of more than one year, the annual basis of accounting requires that the computation of income for tax purposes show the net result of all of the taxpayer's transactions during the year rather than the net result of any particular transaction which may extend beyond that period. *Guaranty Trust Co.* v. *Commissioner*, 303 U.S. 493, 494, 498. As this Court observed in *Sanford & Brooks Co., supra* (pp. 363, 364–365):

> All the revenue acts which have been enacted since the adoption of the Sixteenth Amendment have uniformly assessed the tax on the basis of annual returns showing the net result of all the taxpayer's transactions during a fixed accounting period, either the calendar year, or, at the option of the taxpayer, the particular fiscal year which he may adopt. * * *
>
> * * * * * * *
>
> A taxpayer may be in receipt of net income in one year and not in another. The net result of the two years, if combined in a single taxable period, might still be a loss; but it has never been supposed that that fact would relieve him

> from a tax on the first, or that it affords any reason for postponing the assessment of the tax until the end of a lifetime, or for some other indefinite period, to ascertain more precisely whether the final outcome of the period, or of a given transaction, will be a gain or a loss.

In the instant cases, notwithstanding the possibility that customers might in later years default in their payments, the amounts credited to taxpayers, like the rest of their gain from the sales made during the year, constituted income which was required to be reported on an annual, rather than a transactional, basis.

II. The administrative practice

The clear and consistent administrative practice of the Internal Revenue Service in treating amounts credited to dealers' reserves, in the conventional situations reflected in the instant cases, as the accrued income of taxpayers in whose favor the credits are made, carries substantial weight. As this Court said in *Lucas* v. *American Code Co.*, 280 U.S. 445, 449:

> * * * the direction that net income be computed according to the method of accounting regularly employed by the taxpayer is expressly limited to cases where the Commissioner believes that the accounts clearly reflect the net income. Much latitude for discretion is thus given to the administrative board charged with the duty of enforcing the Act. Its interpretation of the statute and the practice adopted by it should not be interfered with unless clearly unlawful.

Again, in *Automobile Club* v. *Commissioner*, 353 U.S. 180, the Court emphasized that the Commissioner's de-

terminations in the area of accounting practices are to be given particular respect.

As early as 1931, approximately nine years before the decision in *Shoemaker-Nash, Inc.* v. *Commissioner,* 41 B.T.A. 417, the first reported case dealing with the dealers' reserve issue, the Internal Revenue Service, in G.C.M. 9571 (Appendix, *infra,* pp. 65–70), announced that credits made by finance companies to dealers' reserves constituted the accrued income of dealers for the years in which the credits were made. The Ruling observed that in the event "the purchaser fails to meet his obligation, the dealer is given the benefit of the reserve credit through a corresponding reduction in his liability to the finance company." In rejecting the contention that no accrual of income occurs when the credits are made, because the purchaser of the automobile might prove delinquent, the Service stated that (Appendix, *infra,* pp. 68–69)—

> inasmuch as the taxpayer has adopted the accrual method of accounting, he must be consistent in the treatment of all items of income. Such treatment, under the accrual method, demands that each item of income shall be accrued when earned rather than when received. This is the basis upon which the theory of "accrual" is founded, and the possibility of an item of earned income not being received due to some unforeseen circumstances is immaterial. It is true that where an entry on the books of account is based on a remote contingency which may never happen such item could not reasonably be accrued for income tax purposes. * * * The contingency must, how-

ever, be something more than the mere possibility of the debtor not satisfying his indebtedness. There is always a possibility, where the relationship of debtor and creditor exists, that the debtor may not pay, due to financial reverses, but if the possibility of such failure to pay is accepted as a reason for not accruing an item of income the whole theory of the accrual method of accounting must fall where commercial transactions are concerned.

* * * The facts show that the reserve credit is not a contingent credit but is paid to the dealer either at the time the note is liquidated by the purchaser of the car or, in case the purchaser fails to meet his obligation, the dealer is given the benefit of the reserve credit through a corresponding reduction in his liability to the finance company. It follows, therefore, that the reserve credit to the dealer is an absolute credit by the finance company and is payable to the dealer without limitation, regardless of whether the obligation is liquidated by the purchaser (who is the maker of the note) or by the dealer (who is the indorser thereof).

Revenue Ruling 57–2 (Appendix, *infra*, pp. 61–64), which reaffirmed G.C.M. 9571 and described with somewhat more particularity the steps generally involved in setting up dealers' reserve accounts,[17] de-

[17] The Ruling states in part:

"When a car is purchased on credit from a dealer, the purchaser makes a down-payment, either in the form of cash or by turning in another car at an agreed value, the balance being satisfied by the purchaser's promissory note and a supporting conditional sales contract. The face amount of the note re-

clared that when the purchaser gives the dealer a note reflecting "the balance of what would be the purchase price of the car, if bought for cash, and a finance charge", the transaction is "closed and completed" as between purchaser and the dealer, *"with the attendant tax consequences to the dealer"*. (Emphasis supplied.) The Ruling also reaffirmed the Service's consistent policy of treating the credits to the dealers' reserve accounts as accruing to the dealers

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flects two elements—the balance of what would be the purchase price of the car, if bought for cash, and a finance charge. * * *

"It is then common practice of the dealer to sell or discount the purchaser's note and sales contract to some financial institution. The finance company or bank acquires the note at a value somewhat less than its face value, the difference representing a charge for its service. Simultaneously, either cash or unrestricted credit is given to the dealer to the extent of the amount reflected in the face value of the note that corresponds to the unpaid balance of the cash retail price of the car. The difference between the face value of the note and the sum of the finance company's charge and its credit or immediate payment to the dealer (representing part of the finance charge previously mentioned) is then credited on the books of the finance company as a liability of the finance company to the dealer. The accumulation of these credits is generally known as a 'dealers reserve' * * *.

"Settlement of the liability represented by the reserve is subject to agreement between the particular dealer and the financial institution involved. In some instances, the agreement does not contemplate the charging of any items against the reserve account, while in others the account reflects a running record of various transactions between the parties, that is, both credits and charges are entered, depending upon the nature of the item. Thus, in certain instances, the dealer and the finance company may agree that notes purchased or discounted are to be charged to the reserve account in the event they become worthless."

as of the time the credits are made—whether the "dealer's reserve is in the nature of a running account" between dealer and finance company (as, for example, where the two parties have agreed that "notes purchased or discounted are to be charged to the reserve account in the event they become worthless"), or whether "losses incurred by a finance company on notes purchased from automobile dealers may not be charged against the reserve * * * even though the dealer is not immediately or even currently able to draw on the entire reserve."

Thus, from 1931 to the present day—a period during the course of which there have been two complete revisions of the Internal Revenue Code—it has been the announced position and the consistent practice of the administrative authorities to treat the very types of credits involved in these cases as constituting the accrued income of those dealers in whose favor the credits stand. During this entire period, Congress has not seen fit to make any change in the law. Cf. *Cammarano* v. *United States*, No. 29, this Term, decided February 24, 1959.

III. The nature of the transactions

The sale and financing arrangements in the instant cases have been recently interpreted by the Courts of Appeals as susceptible of two differing constructions. The first (see *Baird* v. *Commissioner*, B.R. 82, 85; *Schaeffer* v. *Commissioner*, *supra*, 258 F. 2d at 865) is that the arrangements, in their totality, reflect two separate and distinct, albeit practically contemporaneous, transactions: (1) the sale of the commodity

to the purchaser at a total time price, including finance and other charges, the purchaser executing a note or other evidence of obligation in favor of the dealer; and (2) the sale of the paper to a finance company, the latter paying the dealer a certain sum in cash and crediting a certain additional amount to a so-called dealer's reserve account. The second construction (see, *e.g., Hansen* v. *Commissioner,* H.R. 89–90; *Texas Trailercoach, Inc.* v. *Commissioner,* 251 F. 2d 395, 404, (C.A. 5)) is that the total arrangements reflect a single, tripartite, transaction involving the dealer, the purchaser, and the finance company.

The first approach leads necessarily to the conclusion that taxable income accrues to the automobile dealer, just as it accrues to any other seller who makes a sale of property and extends credit to the buyer. Certainly, the fact that a seller may then proceed to borrow from a bank or lending agency by assigning or pledging his accounts receivable does not mean that those accounts have not accrued for tax purposes.

For the reasons elaborated below, we believe it correct to treat as two discrete transactions the sale to the buyer (accompanied by execution of the buyer's note in favor of the seller) and the subsequent sale of the retail paper to the finance company. It is particularly significant (though there are also other factors which support this analysis) that in none of the cases before the Court was the automobile dealer under any legal obligation whatever to discount the paper which he received from the purchasers.

We argue further that, even if one treats the arrangements involving buyer, seller and finance company as constituting a single three-cornered transaction, it is nonetheless erroneous to view the amount held by the finance company in the dealer's reserve account as a contingent liability of the finance company not yet accrued by the dealer. The essential consideration here is that the dealer, by disposing of the retail paper instead of holding it himself, has nowise added to the risks or contingencies. The risk of his not being paid in full is the same risk as if he had held the paper himself—that the buyer of the automobile may default on his obligation and that the repossessed car may prove insufficient in value to satisfy the debt. The fact remains that the dealer has accrued his gain upon the completion of the sale. The risk is no more than the normal risk of any commercial seller who has sold on credit rather than for cash.

Thus, we submit, either approach should lead to the same tax result.

A. *The two-transaction hypothesis*

In each of the instant cases, taxpayers—not the finance companies—sold the commodities involved. Each sale was evidenced by an agreement between dealer and purchaser whereby the purchaser was obligated to pay a total time price. The time price included, among other things, the finance charge. The major portion of that charge was to be ultimately received by the finance company; a portion of it,

however, was allocated to the dealer.[18] Insofar as the purchaser was concerned, the total time price (including finance and other charges) which was evidenced by the face amount of the paper made payable to the dealer represented the price of the commodity—just as the cash amount paid would have been so regarded if the purchaser had bought the commodity outright; just as the amount paid on a time basis would have been so considered if the dealer himself had chosen to retain the retail paper. Nor can there be any real doubt that *taxpayer-dealers* regarded the

[18] In *Hansen*, the amended petition filed by taxpayer in the Tax Court admitted (H.R. 10) that "The contract between petitioners and G.M.A.C. required that a contingent liability reserve, called 'Dealer's Reserve,' be withheld by GMAC out of the finance charges." The Commissioner's explanation of adjustments for the taxable years recognized that the finance charge was included in the gross sale price of each automobile, and that the finance charges had been withheld by G.M.A.C. under its retail financing plan, in "a contingent reserve for possible losses." (H.R. 18, 21.) Taxpayer testified that (H.R. 30): "we figured the cash price on the car, deducted * * * [the] down payment and then computed what the finance cost would be on the unpaid balance and what the monthly payments would be * * *." The premise of taxpayer's argument in the Tax Court was that the amounts withheld by G.M.A.C. and credited to the "Dealer's Reserve" represented finance fees. (H.R. 43, 45.) The Tax Court found that the "Total Time Price" for each automobile sold included "the cost of any insurance and finance charges"; that under the reserve account maintained between taxpayer and G.M.A.C. "at least 5 per cent of the outstanding balances of the contracts assigned to GMAC were retained by it"; and that "in the event of prepayment by a customer, the proportionate reduction in finance charges was charged to the reserve." (H.R. 61, 63–64.) In the Statement of Points before the Court of Appeals taxpayer adverted to the "finance fees withheld in contingent liability reserve by General Motors Acceptance Corporation." (H.R. 76.)

total time payment—including, certainly, that portion of the finance charges allocable to them—as the *quid*

The record in *Glover* makes no specific reference to the composition of either the time charge to taxpayer's purchasers, or of the credits to the dealer's reserve account. The agreement with the Universal C.I.T. Credit Corporation provided that the finance company's "rate charts will include, for * * * [the] protection * * * [of taxpayer] reserves as outlined in * * * [the] reserve arrangement effective at the time paper is purchased by" the finance company. (G.R. 28.) The Court of Appeals simply concluded that taxpayer received "notes of purchasers representing the balance due on the purchase price"; that the notes were sold to the finance company "pursuant to a written contract prepared by the finance company"; that "On transfer and delivery of the notes the taxpayer received 97% of the face value of the notes and the finance company withheld 3% and this transaction was evidenced on the books of the finance company by an entry of this 3% * * * in an account called the dealer's reserve account." (G.R. 36–37.)

In the *Baird* case it was stipulated that in connection with the sale of trailers under conditional sales contracts "the purchaser executed a note payable to the partnership for the unpaid purchase price of the trailer, plus insurance, interest and financing charges" (B.R. 15); that "Under the terms of its agreements with the three finance companies, the partnership sold most of its trailer notes to the finance companies for the deferred purchase price of the trailers plus in certain cases a percentage of the interest or finance charges"; that "The amount withheld and credited to * * * [the reserve account] was usually 5 percent of the unpaid balance on each note * * * [in some instances, only 3 percent, and that] in certain instances, Minnehoma and Midland also credited to the partnership's account a portion of the finance charge" (B.R. 16; Ex. 12-L, B.R. 31–32; Ex. 13-M, B.R. 36–37). See also Exhibit 18-R (B.R. 40–42), in which one of the finance companies (Midland) announced that it was setting up "a dealer profit reserve equal to 1% of the unpaid cash balance of each retail contract * * * derived from the service charge and * * * [to] be paid to the dealer when the retail contract is paid out."

pro quo for their sale of the commodities. The Court of Appeals in the *Hansen* case recognized as much, in subscribing to the Fifth Circuit's view, expressed in *Texas Trailercoach, Inc.*, v. *Commissioner, supra*, 251 F.2d at 397, that "When we get down to what actually happens * * * the finance company * * * has a *fixed percentage for its finance charges worked into the sales price.*" (H.R. 90.) (Emphasis supplied.) The correctness of that view is indicated by even a cursory examination of the origin, development, and function of the practice of dealer participation in finance charges. See Hardy, *Another View On The Origin of Dealer Participation In Automobile Finance Charges*, 30 Ind. L.J. 311 (1955).[19]

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[19] According to the author, the practice of adding to the finance charge a part to be collected from the purchaser and paid to the dealer was originated by General Motors Acceptance Corporation (GMAC) some time in 1925. Prior thereto, notes taken by dealers in retail transactions were simple promissory notes, in a principal amount equal to the balance due by the purchaser, bearing a percentage rate of interest. Generally, the dealers retained the notes or transferred them variously to GMAC, other finance companies, or banks, according to their own interests. The principal advantage of the transfers by dealers was the conversion of their notes to cash, in effect making the sales of cars cash transactions. The dealers did not expect profit on the sale of the notes, and it was virtually non-existent. By 1925 it became clear to GMAC that it was losing much of its business to independent finance companies and others. In order to meet that exigency (as well as to assure, to the greatest extent possible, its control of the business of financing the sales of General Motors cars) GMAC decided, in the latter part of 1925, to inaugurate, among other things, a dealer profit participation in the finance charge. By the end of 1926—GMAC's volume of business and net earnings having increased by approximately 225 percent over the previous year—the dealer participating practice was perma-

In none of the instant cases was the taxpayer-dealer legally obligated to sell any of its retail paper to the particular finance company or companies with which it did business, or, indeed, to any company at all.

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nently fastened to a large part of the automobile business (General Motors' proportion of the business was about 40 percent at that time). Knowledge of GMAC's success spread at once throughout the automobile business, with the result that other motor companies (Chrysler through Commercial Credit, and Ford through Universal Credit) followed suit. And since Ford and Chrysler then represented about fifty percent of the automobile business, independent finance companies were again confronted with the choice of abandoning a large part of their business or of matching the Ford and Chrysler dealer participation.

See also, Note, *Is Control Of Dealer Participation A Necessary Adjunct To Regulation Of Installment Sales Financing?*, 28 Ind. L.J. 641 (1953); and Pecar, *Dealer Participation In Automobile Finance Charges: A Reply*, 30 Ind. L.J. 319 (1955). While both of these latter articles are addressed primarily (as is the Hardy article, *supra*) to other problems in the field of automobile financing, they, too, make the basic assumption that the amounts credited to the dealers' reserve accounts in the arrangements between dealers and finance companies represent, in intention and reality, part of the purchase price for the commodities sold, ultimately to be paid to the dealers. Thus, the Pecar article, *supra*, p. 321, speaks of the "inclusion of financing costs in the sales price of the automobile." And the Note, *supra*, pp. 644, 649, 658, describes the dealer participation arrangement as the "obvious increment to the finance charge"; as the "first and foremost" method employed by finance companies "to obtain dealer business"; as "the pièce de résistance" among the "methods of enticing dealers", in the case of the smaller finance companies; and as so clearly a means of providing an additional *quid pro quo* to the dealer on the sale of the commodity as to warrant the observation that "Today when a dealer makes arrangements to finance his paper, his first question is, 'How much do I get and when do I get it?'"

Thus, in *Baird,* the court below found that taxpayer (B.R. 85) "had complete freedom of choice in this regard and conversely each finance company was free to take or refuse the offered paper." In *Glover,* it was stipulated that the finance company only *proposed* to buy from taxpayer the paper acceptable to it, and that it could "stop buying" taxpayer's paper, presumably at will. (G.R. 24, 25.) Conversely, nothing in the *Glover* record indicates that taxpayer was legally obligated to sell any paper to the finance company. In *Hansen,* the Tax Court found that (H.R. 63) "There was no specific contract with GMAC requiring petitioner to assign any of his contracts to GMAC * * * or to any other finance company"; on the contrary, taxpayer "could hold such contracts himself without assignment."

In these circumstances, the dealer-purchaser transaction in each of the instant cases was indeed "completed * * * at the time the down payment was made, either in cash or trade-in allowance, or both, and the purchaser executed and delivered to it notes" or other paper, at which time the dealer had a "complete enforcible right to receive the remainder of the purchase price at the times specified in the retail paper." *Baird* v. *Commissioner.* (B.R. 82.) In fact, in *Schaeffer* v. *Commissioner, supra,* 258 F. 2d at 865, the Court of Appeals considered the "prior" dealer-purchaser transaction to be *"the controlling factor in the case,"* the dealer acquiring thereby "an asset in the nature of an account receivable, with respect to which there was no contingency whatsoever," with the resultant accrual of "the entire amount of the contract obliga-

tion." (Emphasis supplied.) Even the *Hansen* opinion appears to acknowledge that "such an approach is entirely consistent with the principles of accrual accounting" and that "[i]t *can* be reasoned that the right to the sale price is fixed at the time of the contract, thereby requiring the dealer to accrue that amount, although he has actual receipt of only 95% thereof * * *." [20] (H.R. 89.) (Emphasis supplied.)

It is, of course, fundamental that an accrual basis taxpayer receiving payment in the form of a promis-

[20] The *Hansen* opinion erroneously suggests that the only amount not includable in the year of sale would be "that portion of the finance charges to which the dealer is entitled as they become fixed". (H.R. 89.) But under the two-transaction hypothesis the finance charge is part of the purchase price agreed to be paid for the commodity, as evidenced by the note issued to the dealer in the amount of the full time price. The *full* purchase price is accruable, regardless of the fact that part of it derives from the charge of servicing the transaction. And even if the two-transaction hypothesis is ignored, and the transaction is considered as a single, tripartite, arrangement involving dealer, purchaser, and finance company, the fact is, nevertheless, that the dealer sells the retail paper, a chose in action, to the finance company for a total consideration (including the component attributable to the service charge) payable partly in cash, and partly on a deferred basis, out of amounts credited to the dealer's favor in the reserve account. The *full* amount to be paid for the paper (including the credits which will ultimately be satisfied by cash payment, or by discharge of the dealer's obligations to the finance company) accrues upon sale of the paper and entry of the credits. Nor can any of the credits in the dealers' reserve accounts in the instant cases be regarded as the payment of interest to the taxpayer-dealers. Interest "is the amount which one has contracted to pay for the use of borrowed money". *Deputy* v. *DuPont*, 308 U.S. 488, 497. No money was borrowed by purchasers from the taxpayer-dealers: the finance companies financed the transactions.

sory note (or any other chose in action) which appears to be collectible cannot refuse to accrue the amount of the obligation merely because it might not prove collectible when due. Indeed, if mere uncertainty of payment, inherent in every debtor-creditor relationship, is to be considered sufficient reason for not accruing an obligation, then the whole theory of accrual accounting in regard to commercial transactions is undermined. See Whittaker, *Accruability of Dealer Reserves Withheld by Finance Company*, 55 Mich. L. Rev. 733, 734 (1957); *Spring City Co.* v. *Commissioner, supra; Automobile Ins. Co.* v. *Commissioner, supra; K. Taylor Distilling Co.* v. *Commissioner, supra; Elmer* v. *Commissioner, supra; Alworth-Washburn Co.* v. *Helvering, supra.* Even if it is assumed that taxpayers in the instant cases fall within the category "of those who, without sufficient capital, enter into a competitive business field, where [assertedly] risks are high and many", the irrelevancy of that fact was correctly noted by the Court of Appeals in the *Baird* case (B.R. 81):

> * * * such an entry is voluntary and we know of no power which courts have to grant relief from the burden of income tax laws to persons who thus find themselves "at the mercy of the finance companies". Congress has power to lay and collect income taxes. If the application of the income tax laws to persons situated as taxpayers say they were, requires special consideration, it is for Congress to say so, not us. Our duty is to ascertain what the law is and apply it * * *".

In any event, however, the records in the instant cases do not support any suggestion of special risk. In the *Baird* case, no delinquencies were charged to the dealer's reserve accounts by any finance company during the taxable years; the total deductions of the partnership for bad debts, only a part of which reflected advances by the partnership to meet purchasers' defaults in payments, amounted to only $1,203.75 for 1952, $2,239.12 for 1953, and $1,203.69 for 1954. (B.R. 78.) The gross sales for each of those years were well over one million dollars. (B.R. 44). In the *Hansen* case, taxpayer charged off bad debts specifically as they became worthless. (H.R. 64.) However, taxpayer testified that the bad debts charged off "had nothing to do * * * with the credit sales of automobiles". (H.R. 32.) His accountant testified that the bad debts appearing on the book of accounts and tax returns "have nothing to do with the financing of automobiles" but were "entirely the result of sales on open account or parts, accessories, repairs, or other bits which incurred incidental to his business." (H.R. 37.) In the *Glover* case, taxpayer deducted the following amounts as bad debt expenses: 1949—$1,897.74; 1950—$7,393.20; 1951—$4,167.05. (G.R. 31.) His gross retail sales for those years from new and used passenger cars, as shown in the copies of the returns which are before this Court (Respondent's Exhibits B, C, D; G.R. 19) were well over three million dollars.

Nor should the fact that the dealer, in lieu of retaining the paper, sold it by "subsequent act" to a finance company "in a transaction which left a part

of the sales price of the paper temporarily retained as security by the finance company" forestall the full accrual of the account receivable resulting from the dealer-purchaser transactions. (*Baird* v. *Commissioner*, B.R. 82.) "The income * * * accrued * * * before the transfer * * * to the [f]inance [c]ompany, and such subsequent transfer does not change the legal effect of the prior completed transaction." *Schaeffer* v. *Commissioner*, *supra*, p. 865; see also, *Chamberlin* v. *Commissioner*, 207 F. 2d 462 (C.A. 6), certiorari denied, 347 U.S. 918.

In this connection, it is immaterial that the sale and financing arrangements in the instant cases may have contemplated, *ab initio*, that the time balances owing by the purchasers would be paid directly to the finance companies. Contrary to the one-transaction hypothesis accepted below in *Hansen* and, presumably, in *Glover*, we submit that the rationale of this Court's decision in *Raybestos-Manhattan Co.* v. *United States*, 296 U.S. 60, requires one to view the dealer-purchaser-finance company arrangements as involving two separate sets of transactions and legal relationships.

In *Raybestos-Manhattan*, corporations A and B, pursuant to a consolidation agreement, conveyed their property to corporation C, in return for shares of C's capital stock. The stock was not issued to A and B but to their stockholders. The taxpayer (corporation C) and the Government were "not in accord as to the precise interpretation to be placed upon the contracts which resulted in the consolidation"; but this Court, "for purposes of decision * * * assume[d] that it was agreed by all concerned that the shares

* * * were to be issued directly to the stockholders of * * * [A and B] without further intervention by the latter". On that hypothesis, it was urged that there was no transfer of shares to A and B within the meaning of the stock transfer tax provisions.

This Court, however, held that the consolidation agreement contemplated (1) the right of A and B to receive the stock in question by virtue of the transfer of their property to C ("the generating source of the right to receive"); and (2) their effective disposition of that right, through the arrangement with C, to have the shares issued directly to their stockholders. In the Court's view, the situation in *Raybestos-Manhattan* was the same *"as if the several legal relationships of the parties had been established at different times and by separate documents"*. This Court did not discern *"even a technical difference of any significance"* between (1) a hypothetical situation in which A and B convey property to C in exchange for C's shares of stock, to be issued as A or B direct, where it is later ordered that the certificates be issued to the stockholders of A and B, and (2) the situation in the case before it, "where the same duty to issue the stock is created and the same shift of the beneficiaries of it is effected *simultaneously in a single document*". (Emphasis supplied.)

By the same reasoning, we submit, in the instant cases the sale of the commodities and execution of retail paper (involving dealer and purchaser) and the transfer of the paper and the entry of credits in the dealers' reserve accounts (involving dealer and finance company) must be regarded for tax purposes

as reflecting "several legal relationships of the parties * * * established at different times and by separate documents" (*Raybestos-Manhattan Co. v. United States*, *supra*, p. 63). There were separate "legal transactions, no one of which is fictitious or so lacking in substance as to be anything different from what it purports to be", each possessing the "reality and genuineness" which require their independent recognition for tax purposes. *Chamberlin* v. *Commissioner*, *supra*, pp. 468–469, 471. Cf. *Gregory* v. *Helvering*, 293 U.S. 465; *Minnesota Tea Co.* v. *Helvering*, 302 U.S. 609; *Higgins* v. *Smith*, 308 U.S. 473; *Commissioner* v. *Court Holding Co.*, 324 U.S. 331; *Bazley* v. *Commissioner*, 331 U.S. 737; *Tennessee, Alabama & G. Ry. Co.* v. *Commissioner*, 187 F. 2d 826 (C.A. 6th).

B. *The single-transaction hypothesis*

Even if it is assumed, *arguendo*, that each sale of commodity, execution of retail paper, transfer of the paper, and entry of credits to a dealer's reserve account constituted a "single three-cornered arrangement involving the dealer, the purchaser, and the finance company" [21] (H.R. 89), the tax result here is,

[21] Paragraph 1 of the agreement between taxpayer in the *Glover* case and the Universal C.I.T. Credit Corporation provided for the sale of paper with recourse only as to the transactions covering certain types of "commercial cars." Paragraph 7, however, provided that if the dealer should "*disclose* any part of this agreement to the customer," the dealer would then be "under full recourse liability * * * on the assignment of paper," regardless of the type of commodity involved. (G.R. 27, 29.) (Emphasis supplied.) This type of provision hardly supports the conclusion that the parties contemplated a single, tripartite arrangement. Such a conclusion

nevertheless, the same. The amounts credited to the dealers' reserve accounts—which, together with the cash payments immediately made by the finance companies to taxpayers, embodied taxpayers' gain—accrued to taxpayers in the year in which the credits were made. In those years, taxpayers' "legal right to * * * [the credits] was undisputed, and * * * only the time of payment was deferred." *Schaeffer* v. *Commissioner, supra* 258 F. 2d at 864. Since taxpayers were on the accrual basis, the inclusion of the credits in income was governed by "the right to receive and not the actual receipt." *Spring City Co.* v. *Commissioner, supra,* 292 U.S. at 184–185; *North American Oil* v. *Burnet, supra,* 286 U.S. at 423.[22]

The contrary conclusion reached by the courts below in the *Hansen* and *Glover* cases rests, in essence, upon the erroneous premise (rephrased and controverted in *Schaeffer* v. *Commissioner, supra,* 258 F. 2d at 864) that the credits were payable "only upon various conditions precedent, which were contingencies which might bar indefinitely the dealer's receipt of the payments or the right to receive any payments at all from the account, thus constituting them contingent credits, rather than accrued income." There is no clear-cut test by which to determine whether a

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would be anomalous, indeed, where it was contemplated that two of the parties (dealer and finance company) would keep the terms of their agreement beyond the knowledge of the third party (the purchaser).

[22] See fn. 16, *supra*, as to the application of the claim of right doctrine to taxpayers' fixed right to receive the amounts reflected in the dealers' reserve accounts (either in cash, or in the discharge of their obligations to the finance companies).

right to receive is sufficiently contingent to prevent accrual. See Holland, *Accrual Problems in Tax Accounting*, 48 Mich. L. Rev. 149 (1949). What is a substantial contingency is basically a question of degree. 2 Mertens, *Federal Income Taxation* (Rev.), Sections 12.61 and 12.62. This much, however, is clear. The possibility that a purchaser, solvent at the time of sale, will default is not the type of substantial contingency which will justify deferring the accrual of income. The opinions in *Hansen* and *Glover* have "failed to show in what respect the dealer reserve arrangement involves any greater contingency" than purchaser default. See, Note, *Taxation-Deferred Income-Amounts Credited To "Dealer Reserve" Account Are Income To Accrual Basis Taxpayer When Credited*, 42 Minn. L. Rev. 151, 154 (1957).

The "contingencies" in the instant cases arose in one, or a combination, of the following contexts: (a) where the credits were pledged to cover the finance company's losses arising out of defaults in, or acceleration of, the payments by purchasers; (b) where the credits were pledged to cover the liabilities of the dealer to the finance company, arising out of the guaranty in connection with the sale of the retail paper, or out of other contractual arrangements; and (c) where, without provision for any corresponding depletion of the dealer's reserve account, the dealer incurred a matured obligation of any nature to the finance company. Thus, in the *Glover* case, taxpayer apparently sold most of the retail paper without

recourse.[23] There was no agreement for charging individual worthless notes to the dealer's reserve. While it is true that the Court of Appeals considered that there were (R. 40) "at least four specific unperformed obligations of taxpayer, the nonperformance of any one of which would have changed the amount of the reserve withheld to which * * * [taxpayer] might claim a right in the future," fulfillment of these obligations took place only upon the occurrence of a condition subsequent, and none involved the contemporaneous depletion of the credits to the dealer's reserve account. On the contrary, the finance company was required, "[t]hree times in each twelve-month period" to pay over to taxpayer the "accumulated reserves in excess of 3% of the * * * aggregate unpaid balances" on all paper which it had purchased from taxpayer; prolonged retention of the entire reserves would occur *only* when the finance company stopped buying taxpayer's retail paper, at which time, it was agreed, the finance company could "hold and apply all reserves until liquidation of all paper purchased from [taxpayer] is completed." (G.R. 28.) It is apparent, moreover, that in any event taxpayer ultimately would receive the full amount credited to the dealer's reserve account in cash or in the discharge of his obligations to the finance company.[24]

[23] The agreement with the Universal C.I.T. Credit Corporation provided for the purchase of all retail paper "without recourse as to the customer's obligation of payment," except as to paper covering certain types of "commercial cars," and "cars sold to relatives or employees." (G.R. 23.)

[24] If so applied, the taxpayer would, of course, realize income the same as if he had actually received the amounts credited.

In the *Hansen* case, the endorsement executed by taxpayer upon the assignment of each contract to G.M.A.C. included a guaranty to pay to the finance company "the full amount remaining unpaid" by the purchaser, and a covenant that "if default be made in payment of any instalment" by the purchaser taxpayer would "pay the full amount then unpaid to General Motors Acceptance Corporation upon demand." (Joint Ex. 5–E; H.R. 39–40.) The Tax Court found that the purpose of the dealer's reserve account was "to protect GMAC against any loss arising from the repossession of any automobile in case of default in payment," and also, "in the event of prepayment by a customer," against the "proportionate reduction in finance charges." (H.R. 63–64.)[25] Here, too, there was no provision for current depletion of the reserve account, except possibly in the case of finance charge refunds attributable to prepayments. In any event, as in the *Glover* case, taxpayer

Old Colony Trust Co. v. *Commissioner*, 279 U.S. 716, 729; *Tressler* v. *Commissioner*, 228 F. 2d 356, 359 (C.A. 9th). The charging of the reserves in the instant cases involved, in substance, cancellation of taxpayers' obligations, giving rise to a form of income. *United States* v. *Kirby Lumber Co.*, 284 U.S. 1; *Clarke* v. *United States*, 94 F. Supp. 543 (E.D. Pa.), affirmed, 189 F. 2d 101 (C.A. 3d); 2 Mertens, *Federal Income Taxation*, Sec. 11.19 (1955).

[25] Taxpayer testified that the dealer's reserve account maintained by G.M.A.C. "was a reserve set up *in case that I folded up* it would protect the finance company to repossess; the cars would be worth less than what the contract calls for to pay back G.M.A.C. Also, in case of any prepayment on contracts, there would be a reserve there, then refund the customer part of the financing cost, which would be chargeable in direct proportion from what I received on the financing costs." (H.R. 31.) (Emphasis supplied.)

would ultimately receive in cash the amounts credited to the dealer's reserve account, or would realize income upon the application of those credits to the discharge of his obligations to the finance company, arising out of the aforementioned guaranty and covenant.

In the *Baird* case, the partnership either endorsed the retail paper sold to the finance company, with recourse, or guaranteed payment. In addition, the agreements with the finance companies provided, in effect, that each finance company could look to the balance in the dealer's reserve account to cover any default by purchasers, any repossession losses, or any default by the partnership with respect to its guarantees or other matured financial obligations, of any nature, to the finance companies. While it was possible, as the Court of Appeals observed, that the partnership "would not receive all of the amounts in cash, the parts withheld would in all events be used for the benefit of the partnership to satisfy its future obligations, if any, to the finance companies." (B.R. 86.) Here, too, then, "Ultimately only two things could happen to the funds in the dealer's reserve accounts: either the amounts would be paid * * * in cash or they would be used to satisfy * * * [taxpayer's] other obligations to the finance companies."[28] (B.R. 82.)

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[28] That at least one of the finance companies so understood the effect of the arrangements with taxpayer is indicated in the testimony of Midland's vice president. Asked for the reason that the dealer reserve account was "set * * * up * * * to protect the finance company against possible loss," he stated (B.R. 27):

"Well, we buy this paper from all of our dealers on a

This feature, common to the three cases, distinguishes them from other situations in which taxpayers might receive no income in any form. See, for example, the so-called cooperatives' reserve cases (*Long Poultry Farms* v. *Commissioner*, 249 F. 2d 726 (C.A. 4th); *Commissioner* v. *Carpenter*, 219 F. 2d 635 (C.A. 5th)), in which the taxpayer-patrons held patronage certificates representing shares in the cooperatives' net profits. These shares were subject to diminution in case the cooperatives sustained losses; were subordinate to the right of the cooperatives' creditors and all preexisting unpaid patronage certificates; and would not be paid unless and until the cooperatives' directors so resolved. These contingencies could operate to diminish the amount of cash ultimately to be received by the taxpayer-patrons without offset by any other increment in their wealth, such as a discharge of any indebtedness from the patrons to the cooperatives. See Conner, *Taxation: Federal Income Tax: Dealers' Reserves: Time When Accruable as Income: Texas Trailercoach, Inc.* v. *Commissioner*, 251 F. 2d 395 (5th Cir. 1958), 43 Corn. L.Q. 719, 722 (Vol. 4, 1958). It is true, in the instant cases, that cash payment of the credits held in reserve were to be made only when the total credits exceeded a certain percentage of the unpaid balances on all contracts or retail paper. It by no means follows that the credits did not accrue. Cf. *Keasbey & Mattison Co.*

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straight endorsed basis, in other words, it's fully recoursed. If a trailer is given to a note-maker and the note-maker can't pay for it, the dealer has to take it back, if he can't pay us off, then, the net pay-off on the trailer, we would take the reserve money to liquidate the account."

v. *Commissioner*, 141 F. 2d 163, 167, 168 (C.A. 3d), in which the court observed that such provisions would appear to affect "merely * * * the time of", not the right to, payment, in which event the reserve should be reportable at the time of sale, since under a universally recognized principle, it is the right to receive, not actual receipt, which controls the accruability of income.

Taxpayers' real grievance in the instant cases would seem to be (H.R. 87–88) "that a tax must be paid without the funds upon which the tax is levied being available for payment of the tax." But, as the Court of Appeals correctly pointed out in the *Hansen* case (*ibid.*), "This may often be the result of accrual accounting just as it may be the result of operation of the doctrines of realization and constructive receipt." Under "basic concepts," an accrual basis taxpayer "must record income, and pay tax thereon, upon *fixation* of the right to receive income." The time of payment cannot control.

CONCLUSION

The judgments of the courts below in Nos. 380 and 381 cases should be reversed. The judgment of the Court of Appeals in No. 512 should be affirmed.

Respectfully submitted.

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APPENDIX

Internal Revenue Code of 1939:

SEC. 22. GROSS INCOME.

(a) *General Definition.*—"Gross income" includes gains, profits, and income derived from salaries, wages, or compensation for personal service, of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. * * *

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(26 U.S.C. 1952 ed., Sec. 22.)

SEC. 41. GENERAL RULE.

The net income shall be computed upon the basis of the taxpayer's annual accounting period (fiscal year or calendar year, as the case may be) in accordance with the method of accounting regularly employed in keeping the books of such taxpayer; but if no such method of accounting has been so employed, or if the method employed does not clearly reflect the income, the computation shall be made in accordance with such method as in the opinion of the Commissioner does clearly reflect the income. If the taxpayer's annual accounting period is other than a fiscal year as defined in section 48 or if the taxpayer has no annual accounting period or does not keep books, the

net income shall be computed on the basis of the calendar year.

(26 U.S.C. 1952 ed., Sec. 41.)

SEC. 42 [as amended by Sec. 114, Revenue Act of 1941, c. 412, 55 Stat. 687]. PERIOD IN WHICH ITEMS OF GROSS INCOME INCLUDED.

(a) *General Rule.*—The amount of all items of gross income shall be included in the gross income for the taxable year in which received by the taxpayer, unless, under methods of accounting permitted under section 41, any such amounts are to be properly accounted for as of a different period. * * *

* * * * * *

(26 U.S.C. 1952 ed., Sec. 42.)

Rev. Rul. 57–2, 1957–1 Cum. Bull. 17:

Amounts withheld by banks or finance companies to cover possible losses on notes purchased from dealers constitute income to dealers employing the accrual method of accounting, to the extent of their interest therein at the time the amounts are recorded on the books of the bank or finance company as a liability to the dealer, regardless of whether charges for worthless notes are also made to the account pursuant to an agreement between the parties. Losses sustained on worthless notes shall be separately established by the dealer as required by section 166 of the Internal Revenue Code of 1954.

The Internal Revenue Service has been requested to state its position with respect to the treatment, for Federal income tax purposes, of amounts withheld by banks and finance companies to cover possible losses on notes purchased from automobile or other dealers employing the accrual method of accounting, and which are recorded on the books of the bank

or finance company as a liability of the bank or finance company to the dealer.

The steps generally involved in transactions concerning automobile dealers are as follows: When a car is purchased on credit from a dealer, the purchaser makes a down-payment, either in the form of cash or by turning in another car at an agreed value, the balance being satisfied by the purchaser's promissory note and a supporting conditional sales contract. The face amount of the note reflects two elements—the balance of what would be the purchase price of the car, if bought for cash, and a finance charge. As between the purchaser and the dealer, the transaction is closed and completed at this point with the attendant tax consequences to the dealer.

It is then common practice for the dealer to sell or discount the purchaser's note and sales contract to some financial institution. The finance company or bank acquires the note at a value somewhat less than its face value, the difference representing a charge for its service. Simultaneously, either cash or unrestricted credit is given to the dealer to the extent of the amount reflected in the face value of the note that corresponds to the unpaid balance of the cash retail price of the car. The difference between the face value of the note and the sum of the finance company's charge and its credit or immediate payment to the dealer (representing part of the finance charge previously mentioned) is then credited on the books of the finance company as a liability of the finance company to the dealer. The accumulation of these credits is generally known as a "dealers reserve" and is the specific object to the present consideration.

Settlement of the liability represented by the reserve is subject to agreement between the particular dealer and the financial institution involved. In some instances, the agreement

does not contemplate the charging of any items against the reserve account, while in others the account reflects a running record of various transactions between the parties, that is, both credits and charges are entered, depending upon the nature of the item. Thus, in certain instances, the dealer and the finance company may agree that notes purchased or discounted are to be charged to the reserve account in the event they become worthless.

With regard to those instances where losses incurred by a finance company on notes purchased from automobile dealers may not be charged against the reserve, the credits to the reserve, by the finance company in favor of a dealer who employs the accrual method of accounting constitute income to the dealer at the time such credit is made, even though the dealer is not immediately or even currently able to draw on the entire reserve. See G.C.M. 9571, C.B.X.–2, 153 (1931), and *Shoemaker-Nash, Inc.* v. *Commissioner,* 41 B.T.A. 417. The principles involved in the purchase of notes from automobile dealers by banks or finance companies as described above are equally applicable where notes are purchased, under similar conditions, from dealers in items other than automobiles.

Where a dealer's reserve is in the nature of a running account, the charging thereto of worthless notes pursuant to agreement between the parties has no bearing upon the fact that taxable income has been received by the dealer, or upon the time of its realization as otherwise evidenced by the credits to such reserve.

Accordingly, it is held that credits to such reserve, in the case of a dealer employing the accrual method of accounting, constitute income to the dealer at the time such credits are made regardless of whether charges to the account for worthless notes are also made pursuant to an agreement between the parties.

Losses sustained on worthless notes are to be separately established by the dealer as required by the provisions of section 166 of the Internal Revenue Code of 1954 relating to bad debts.

In arriving at these conclusions, consideration has been given the case of *Blaine Johnson et al.* v. *United States,* 233 Fed. (2d) 952. See also, *Albert M. Brodsky et ux.* v. *Commissioner,* 27 T.C. No. 23.

Treasury Regulations 111, promulgated under the Internal Revenue Code of 1939:

SEC. 29.41–1. *Computation of Net Income.*—Net income must be computed with respect to a fixed period. Usually that period is 12 months and is known as the taxable year. Items of income and of expenditure which as gross income and deductions are elements in the computation of net income need not be in the form of cash. It is sufficient that such items, if otherwise properly included in the computation, can be valued in terms of money. The time as of which any item of gross income or any deduction is to be accounted for must be determined in the light of the fundamental rule that the computation shall be made in such a manner as clearly reflects the taxpayer's income. If the method of accounting regularly employed by him in keeping his books clearly reflects his income, it is to be followed with respect to the time as of which items of gross income and deductions are to be accounted for. (See sections 29.42–1 to 29.42–3, inclusive.) If the taxpayer does not regularly employ a method of accounting which clearly reflects his income, the computation shall be made in such manner as in the opinion of the Commissioner clearly reflects it.

SEC. 29.41–2. *Bases of Computation and Changes in Accounting Methods.*—Approved standard methods of accounting will ordinarily be regarded as clearly reflecting income. A

method of accounting will not, however, be regarded as clearly reflecting income unless all items of gross income and all deductions are treated with reasonable consistency. See section 48 for definitions of "paid or accrued" and "paid or incurred." All items of gross income shall be included in the gross income for the taxable year in which they are received by the taxpayer, and deductions taken accordingly, unless in order clearly to reflect income such amounts are to be properly accounted for as of a different period. But see sections 42 and 43. See also section 48. For instance, in any case in which it is necessary to use an inventory, no method of accounting in regard to purchases and sales will correctly reflect income except an accrual method. A taxpayer is deemed to have received items of gross income which have been credited to or set apart for him without restriction. (See sections 29.42–2 and 29.42–3.) On the other hand, appreciation in value of property is not even an accrual of income to a taxpayer prior to the realization of such appreciation through sale or conversion of the property. (But see section 29.22(c)–5.)

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Treasury Regulations 118, Sections 39.41–1, 339.41–2, promulgated under the Internal Revenue Code of 1939, applicable to the years 1952, 1953, and 1954 contain provisions similar to the above-quoted sections of Treasury Regulations 111.

G.C.M. 9571, X–2 Cum. Bull. 153 (1931):

> The taxpayer is engaged in the business of retail dealer in automobiles and finances through a finance company the time payments on sales of the cars. No formal contract between the finance company and each dealer is entered into, but in a printed booklet there are stated the principal features of the plan, one of which is a reserve maintained by the

finance company to the credit of the dealer for payment to the dealer as an account is liquidated.

When a dealer sells a car on the installment plan the purchaser executes a note for the unpaid purchase price plus a specified service charge, payable to the dealer and bearing interest at the rate of —— per cent. The note is indorsed by the purchaser and afterwards by the dealer.

The contract is then assigned by the dealer to the finance company, which remits to the dealer the amount of the face of the purchaser's note, less the service charge that has been included therein. This service charge includes the reserve which is credited by the finance company to the dealer's account. Thus the dealer, in addition to his regular profit from the sale of the automobile, receives as a reserve credit a portion of the service charge. Attached to the check remitted by the finance company to the dealer is a stub reading as follows: "Dealer, your reserve credit on this contract No. ——— is $ ———." The name and address of the purchaser are also shown on the stub. The reserve is held to the credit of the dealer and is paid to it when the account is liquidated.

The taxpayer, upon receipt of the check from the finance company in settlement of the contract, enters the amount of the reserve credit on its books by debiting "reserve fund finance company" and crediting "reserve for contingent asset of finance company." This same method is used by most dealers, though the accounts debited and credited are sometimes captioned differently. The taxpayer contends that the amount of reserve credit has not been earned because it is not known in advance whether the purchaser will completely liquidate the liability to the finance company, which is necessary before the finance company will pay the dealer.

It appears, however, that if the purchaser fails to pay, the dealer immediately becomes liable on his indorsement and is required to pay the balance due, less his reserve on the particular contract, which stands to his credit on the books of the finance company. This is in accordance with that company's method of making payment, though not specifically mentioned in the plan.

The taxpayer's books of account are kept on the accrual basis and in such cases it has been the practice of the internal revenue agent in charge to treat the reserve as an accrued item of income at the time the credit is made in favor of the dealer. The question is now presented whether this method is correct or whether the reserve credit should be treated as accrued income at the time the notes are finally liquidated, upon the theory that the income in question is contingent upon the purchaser satisfying the outstanding notes. Under the provisions of section 41 of the Revenue Act of 1928, the general rule is that net income shall be computed upon the basis of the taxpayer's annual accounting period "in accordance with the method of accounting regularly employed in keeping the books of such taxpayer." Under the provisions of section 42 of the Revenue Act of 1928, the amount of all items of gross income shall be included in the gross income for the taxable year in which received by the taxpayer "unless, under methods of accounting permitted under section 41, any such amounts are to be properly accounted for as of a different period."

The accrual system of accounting is one of the "methods of accounting permitted under section 41," and recognized by the Bureau. (See articles 88, 322, and 341 of Regulations 74.) Under the accrual system of accounting receipts and disbursements are deemed received and disbursed when the income is accrued and

the liabilities are incurred. (See *American Can Co.* v. *Bowers,* 35 Fed. (2d), 832.) In *Rouss* v. *Bowers* (30 Fed. (2d), 628) the Circuit Court of Appeals for the Second Circuit said:

"When a trader keeps books on an accrual basis, the price of a sale of goods is treated as received when the account receivable is acquired, though not yet collected, and liabilities incurred are treated as outgo, though not yet paid; the receivables and liabilities are forthwith entered on the books and the bookkeeping entries are considered for tax purposes as the equivalent of actual receipts and disbursements."

The courts have repeatedly held that where a taxpayer has adopted the accrual method of accounting all income earned and liabilities incurred must be accrued uniformly in order properly to reflect the taxpayer's income. (*Aluminum Castings Co.* v. *Routzahn,* 31 Fed. (2d), 669; *Miller & Vidor Lumber Co.* v. *Commissioner,* 39 Fed. (2d), 890, Ct. D. 235, C.B. IX–2, 314; *Pittsburgh Hotels Co.* v. *United States,* 63 Ct. Cls., 475; *United States* v. *Anderson,* 269 U.S. 422, T.D. 3839, C.B.V–1, 179; *Vang* v. *Lewellyn,* 35 Fed. (2d), 283, Ct. D. 134, C.B. VIII–2, 283.)

In the instant case the taxpayer uses the straight accrual method of reporting income and the only question involved is whether a reserve credit allowed by the finance company to the dealer should be treated as income when the notes are accepted by the finance company and the reserve is credited, or whether the accrual of the income should be postponed until the purchaser of the automobile liquidates his indebtedness. It is the opinion of this office that inasmuch as the taxpayer has adopted the accrual method of accounting, he must be consistent in the treatment of all items of income. Such treatment, under the accrual method, de-

mands that each item of income shall be accrued when earned rather than when received. This is the basis upon which the theory of "accrual" is founded, and the possibility of an item of earned income not being received due to some unforeseen circumstances is immaterial. It is true that where an entry on the books of account is based on a remote contingency which may never happen such item could not reasonably be accrued for income tax purposes. (See G.C.M. 7514, C.B. IX–1, 111, relating to New York transfer tax on contingent remainders.) The contingency must, however, be something more than the mere possibility of the debtor not satisfying his indebtedness. There is always a possibility, where the relationship of debtor and creditor exists, that the debtor may not pay, due to financial reverses, but if the possibility of such failure to pay is accepted as a reason for not accruing an item of income the whole theory of the accrual method of accounting must fall where commercial transactions are concerned.

In the instant case there is just as much reason for accruing the reserve which is credited to the dealer by the finance company as there is for accruing the profit derived by the dealer as the result of the sale of the automobile. The facts show that the reserve credit is not a contingent credit but is paid to the dealer either at the time the note is liquidated by the purchaser of the car or, in case the purchaser fails to meet his obligation, the dealer is given the benefit of the reserve credit through a corresponding reduction in his liability to the finance company. It follows, therefore, that the reserve credit to the dealer is an absolute credit by the finance company and is payable to the dealer without limitation, regardless of whether the obligation is liquidated by the purchaser (who is the maker of the note) or by the dealer (who is the indorser thereof).

In view of the foregoing, it is concluded that the taxpayer, which is the retail dealer, should accrue the income in question at the time the reserve is credited to its account by the finance company.